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RECENT UNITED STATES INTERNAL REVENUE SERVICE AND TAX COURT POLICY ON RECONSTRUCTING NET INCOME AND FRAUD PENALTIES

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IN SUPPLEMENTING our articles on "New Policy Adopted by Internal Revenue Bureau in Federal Fraud Cases",[1] "Statute of Limitations in Income Tax Criminal Penalty Cases, a Dangerous Trap",[2] "The Civil Penalties of Income Tax Evasion"[3] and "Defenses to the Charge of Income Tax Fraud",[3a] we are writing this article to give a more complete and up-to-date coverage on the problem.

In the government's drive against racketeers uncovered by the Kefauver and King Committees of Congress, the problem of reconstructing net income has come again to the fore and is of great interest and consequence to all taxpayers as well to their legal advisors.

All accountants and attorneys engaged in computing income are familiar with the methods used in establishing it. Income is computed from the books and records of the taxpayer, when available and well kept. Otherwise, the government starts building up its case for civil or criminal penalties by reconstructing the taxpayer's income from his bank deposits, net worth plus living expenses, or by the percentage mark up basis where purchases or gross sales can be found out and where inventories are an indispensable income-producing factor. There are innumerable decisions by the Tax Court concerning the reconstruction of income by the Commissioner of Internal Revenue. In order to clarify this problem as much as possible, we are giving some of the most recent decisions on the subject.

In considering whether a taxpayer's books and records are accurate and adequate, it is important to see whether they follow the accounting procedures established by the American Institute of Accountants for correct public audits.

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1 COMMERCIAL LAW JOURNAL, October, 1952; DICK. L. REV., November, 1952; TAXES, January, 1953.

2 THE JOURNAL OF THE BAR ASSOCIATION OF THE DISTRICT OF COLUMBIA, August, 1951; NEVADA STATE BAR JOURNAL, July, 1951; TEXAS BAR JOURNAL, October, 1951; WOMEN'S LAWYERS JOURNAL, Winter, 1951-1952.

3 KENTUCKY STATE BAR JOURNAL, December, 1951; MONTHLY TAX DIGEST, March, 1952.

3a MISSOURI LAW REVIEW, April, 1954.

The books should reflect all the moneys passed through the taxpayer's hands, and traceable through his books and records to their source.

The net worth method is considered by some experts a better way of reconstructing income than the bank deposit method. This method may also be used as a means of upholding an income established by the use of the bank deposits-expenses method.

Under the bank deposit method it is assumed by the government that all bank deposits depict income unless satisfactorily explained to be otherwise by the taxpayer. The only permissible deductions from it are those that the taxpayer can finally and adequately establish as legally allowable.

The percentage or unit mark-up method is used by the government where inventories are a necessary income-determining factor, but were not kept or were incorrectly taken. In order to use this method, the gross sales or purchases made must be known. In some instances, the government attains this knowledge from deposits made in banks and gross receipts; then it applies this method.

In addition to the Commissioner's reconstruction of income by the methods previously mentioned, the Tax Court often does its own reconstruction, in some instances favoring the taxpayer.

When a revenue agent checks up on a taxpayer's return by examining his books at his place of business, he tries to establish whether the taxpayer's income tax return is a true reflection of his income as shown by his books and records. Before he gets down to the taxpayer's office, often a good deal of time has been already spent by the agent in studying the history of the case, the previous returns of the taxpayer, and any previous agents' reports on the taxpayer. He is on the lookout for any discrepancies, changes in income, increases in deductions, etc.

All taxpayers, with the exception of farmers (whose income is solely derived from farming) and wage-earners, must keep necessary records that correctly show their income.[4] Wilful failure to do so is a misdemeanor and punishable as such.[5]

The Code in Section 41 provides that where no adequate records are kept "the Commissioner may make such computation in accordance with such methods as in his opinion clearly reflects the taxpayer's income."

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[4] INTERNAL REVENUE CODE, § 29.54-1.
[5] INTERNAL REVENUE CODE, § 145(a).

In the most recent case on this subject, the court upholding the Commissioner, held as follows:

> "The owner of a business need not be an accountant or bookkeeper to be familiar with the books and affairs of his business. If the inability of an owner to be familiar with the books and affairs of a business could be accepted as an excuse for filing a false tax return with the Government, he could escape punishment irrespective of guilt. Of course he could not be held liable for innocent clerical mistakes, but he must be held to know that which it is his duty to know and which he solemnly promulgated and placed in a tax return. . . ." [6]

Often those who fail to file tax returns also fail to keep records of their income, thereby trying to conceal the source and amount of their income. The fact that the income is obtained from illegal transactions will not be a defense.

RECENT CASES ON THE SUBJECT OF FRAUD

The Tax Court on March 12, 1953, decided the case of *George M. Still, Inc. v. Commissioner of Internal Revenue*,[7] where the facts were as follows: During the fiscal year that ended July 31, 1945, two of petitioner's officers and stockholders withheld from petitioner corporation the proceeds of certain cash sales and thereby caused sales to be understated in the corporate books. The father of one of these officers was the main and dominant stockholder in petitioner's corporation. He discovered the facts prior to the close of the taxable year and obtained promises of restitution from them. Restitution was actually made in October of 1946. Petitioner's tax returns failed to reflect such sales in its gross income.

The court held that "under the circumstances of this case, petitioner has failed to show that income thus improperly omitted from its returns was offset by a deductible embezzlement loss," that "the subsequent filing of an amended return and payment of taxes shown therein did not deprive the Commissioner of the right to assert the fraud penalty," and that "the Commissioner sustained his burden of alleging and proving fraud by clear and convincing evidence that the corporation's officers ignored proper advice of the corporation's attorneys and accountants in the matter."

In *P. C. and Ethel Petterson, Petitioners v. Commissioner of Internal Revenue, Respondent*,[8] on December 18, 1952, the Tax Court held that the original deficiency in income tax liability was a "proper base for computing the 50% fraud penalty, despite a later reduction in tax deficiency due to loss carry-back from the subsequent year."

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[6] United States v. Banks, 1 U.S.T.C. par. 9158.

[7] 19 U.S.T.C. # 6; Herbert Eck, 16 T.C. 511.

[8] 19 T.C. 486; Nick v. Dunlap, 185 F.2d 674 (5th Cir. 1950); 19 T.C. 486 and 1077; 20 T.C. 83; 200 F.2d 650 (4th Cir. 1952); 107 F. Supp. 501; 108 F. Supp. 353; 35 A.L.R. 2d 761n.

On April 11, 1952, in the case of *Estate of Salvatore Santucio v. Commissioner*[9] the facts were as follows: A fishing partnership, of which the taxpayer's decedent was a member, failed to record a substantial number of sales of boatloads of fish. This was discovered by the Bureau in checking with the purchasers of the fish. The partners did not record all of the sums paid to the crew members because of their objection in having income tax withheld on the full amount of their shares. The Tax Court held that "this was a link, deliberately forged, in the chain of facts which led to the understatement of their income" and upheld the imposition of the fraud penalty upon the taxpayer.

On September 5, 1952, in *Silliman v. Commissioner*[10] the facts were as follows: The petitioner, a lawyer after World War I, recovered for his clients properties vested in the Alien Property Custodian. His clients paid him sums in excess of the amounts allowed by statute to agents and attorneys for such services. The petitioner did not include these excess amounts in his returns. The Tax Court held that "the returns filed by him were false and fraudulent with intent to evade the tax"; therefore, the Commissioner's assessments were allowed; and since the deficiencies were the result of fraud with intent to evade the tax, the fraud penalty was properly imposed.

In *Ziegler v. Commissioner*[11] the Commissioner determined deficiencies in income tax and penalties for the years 1936 to 1947 inclusive, and the issues were raised as to whether the Commissioner properly and lawfully examined petitioner's records for 1943 and 1944, whether the Commissioner's net worth method of computing taxable net income was proper for the years before the Tax Court, whether the fraud penalty was applicable, and whether the statute of limitations has tolled for all the years prior to 1945.

The facts were as follows: Petitioners did not file income tax returns prior to 1929. From 1929 to 1936 inclusive they filed returns showing no tax liability. No return was filed for 1937; for the years 1938 through 1947 they filed returns with the Collector of Internal Revenue for the Kentucky District.

Petitioner, at 13, began his business career, cutting and selling timber from his father's farm. In 1908, he sold his own farm animals and moved to Louisville, Ky., arriving there with $1600. He became a bartender and supplemented his income by putting peanut vending machines and player pianos in to saloons in the city. In 1908 he married. In 1910 he and a partner bought a saloon for $4,900 with a purchase money mortgage of $2,900. In 1912 he sold his interest to his partner and immediately bought another saloon, which

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[9] 11 Tax Ct. Mem. 343.
[10] 11 Tax Ct. Mem. 921.
[11] 11 Tax Ct. Mem. 572.

he later sold for $8,000. At the same time he and his father gave his crippled daughter $19,000 for her future education. From 1913 to 1917 he operated his father's saloon and grocery store until his father sold the grocery. During prohibition days he did not operate the saloon. Upon repeal he took it over and also reacquired the grocery. In 1933 he added a night club and dance floor of 2500 square feet to the saloon. The contract price for the building was $7,300, and the furniture and improvements in the building cost an additional $6,950. Petitioners' living expenses for the years in question were taken into consideration. Improvements on their house were $2,000. On July 26, 1948, they filed a written power of attorney appointing a certain attorney to represent them, requesting and directing that all correspondence, documents, warrants or other data in connection with the case be sent to this attorney.

The Tax Court held in this case that "fraud penalties shall be upheld since petitioners' course of conduct over the years indicated an intention on their part to falsely understate their income," that "notice to petitioners' authorized attorney, when the power of attorney was in full force and effect, directing all communications to be sent to that attorney, was sufficient notice to taxpayers of the Commissioner's intention to re-examine their books," that "the Court approves the net worth method of determining income where taxpayers failed to keep records properly indicating their true income," and that the "statute of limitations does not toll in a fraud case." For a full discussion and citations on the subject, see our article on "Statute of Limitations in Income Tax Criminal Penalty Cases, a Dangerous Trap."[12]

In *Kraftmeyer v. U. S.*[12a] the Tax Court approved deficiencies and fraud penalties where a farmer did not file tax returns and had a net worth increase of about $76,000.

In *Kinsely v. U. S.*[12b] taxpayer physician was found guilty by a jury for having furnished the government with false, fictitious and fraudulent books and records in as much as the fees received from patients shown in his books were less than those actually received. The agents of the government uncovered fifty-five instances of understatement of fees. The verdict was affirmed on appeal.

Another physician in the coal mining district took "hospital cuts" from miners. The miners paid him amounts from their wages in return for his promise to furnish them with hospital care when and if needed. He did not

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[12] THE JOURNAL OF THE BAR OF THE DISTRICT OF COLUMBIA, August, 1951. See also THE NEVADA STATE BAR JOURNAL, July, 1951; TEXAS BAR JOURNAL, October, 1951; WOMEN'S LAWYERS JOURNAL, Winter, 1951-1952.

[12a] 1 U.S.T.C. par. 9328.

[12b] 1 U.S.T.C. par. 9227, *affirming* 1 U.S.T.C. par. 9226.

report the amounts as income and he also omitted some fees he received from some coal companies for professional services. The physician called the "hospital cuts" a nontaxable trust fund. He deposited in the taxable years 1942-1945 more than $65,000 in the bank, which he did not account for on his income tax returns. He made the deposits in a corporate account which he controlled. His conviction for willful evasion of income taxes was upheld by the Circuit Court of Appeals of the Sixth Circuit.[12c]

In *Gariopy v. U. S.*[12d] a doctor's unreported income was uncovered based on a net worth computation. The doctor hinted at a possible "nest egg" in early years that would have increased his net worth for the beginning of the first year (1938) of the Commissioner's determination, but he did not substantiate it. He claimed that the burden of proof was on the government to prove that he did not have such a "nest egg". The government started with 1938 when the doctor had no assets, his liabilities being in excess of his assets in account of loans from relatives while at medical school and while he established a practice. By the end of 1945, his net worth was $128,938.52; and the amount plus his living expenses from 1938 through 1945, plus amounts paid out in repayment of loans made before 1938, was the amount of his income spread out over the eight year period. The doctor was found guilty of willful evasion of taxes, and his conviction was upheld by the Circuit Court of the Sixth Circuit.

In the *James L. Doyett* case[12e] the Tax Court as well as the Circuit Court upheld a fraud penalty imposed where a dentist kept no bank account in his own name since he had a judgment outstanding against himself. He had a bank account in the name of a girl employee, even after she was no longer in his employ, and different bank accounts in his son's name in two different banks. When questioned where he got the money he claimed "that he had that buried in a can in his back yard." The Tax Court, in testing the amount of the reconstructed income based on the bank deposits, compared his taxable income with that of another dentist in the same town. The taxpayer operated three chairs, the other dentist two. The other dentist's gross income on his return for 1942-1947 was $166,757.00; petitioner's income on his return was $67,093.44. The Commissioner increased petitioner's income to $110,712.05. The petitioner tried to account for part of the cash deposits by claiming that he had accumulated $36,000 from 1904 to 1937 in cash, which he described as "jug money". He claimed his uncle kept it for him in that way. He claimed that as a boy from twelve to eighteen, he made $26,000 to $28,000 selling cordwood, peaches and cattle. He claimed he distrusted banks and liked to keep money where he could see and feel it.

[12c] Butterman v. United States, 180 F.2d 853 (6th Cir. 1950).
[12d] 189 F.2d 459 (6th Cir. 1951).
[12e] 10 Tax Ct. Mem. 237.

The Tax Court explained that petitioner's money was kept by his uncle hundreds of miles away. Records of his early earnings were found. They showed that he earned from $75 to $150 per month and that he had no other earnings. His borrowings before 1942 were not consistent with the ownership of $38,000 in jug money.

The Tax Court held that the Commissioner's determination was "conservative". It noted that taxpayer's claim of large earnings as a boy was made so as to bring the income within the years before 1913, the first income tax year.

Taxpayers, their accountants and attorneys must realize that income taxes are the core of United States Revenue producing methods, but it is a great error in thinking that fraud cases cover only income taxes. They may involve other taxes such as: admission, employment, estate, excise, gifts, and transportation taxes.

We must realize that a good many fraud cases arise from the examination of the books and records of people with whom taxpayers did business. Government agents have almost unlimited access to the books and records of such people. They get secondary evidence in this way and obtain secondary proof of taxpayers' books by such inquiries, which often lead to a taxpayer's downfall in fraud cases.[13]

This rule gives the government a strong hand in tax evasion trials which, while standing alone may not be fully convincing may, however, result in the obtention of the original books and records of taxpayer-defendants who desire to contradict or explain away the government's evidence as to the contents of their original books.

This method is used to find out a taxpayer's veracity when questioned by government investigators; in strengthening the government with proof in cases where a taxpayer has changed, mutilated or destroyed his records; and to induce a taxpayer to make his books and records available to the agents of the government since they can tell him that they have the "goods on him".

CONSTITUTIONAL RIGHTS

The individual taxpayer has certain constitutional rights which are not available to corporate taxpayers. The Fourth Amendment protects him from unreasonable searches and seizures of his private books and records. The Fifth Amendment protects him against self incrimination, such as compulsion to

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[13] Lisansky v. United States, 31 F.2d 846 (4th Cir. 1929); Himmelfarb v. United States, 175 F.2d 924 (9th Cir. 1949); Norwitt v. United States, 195 F.2d 127 (9th Cir. 1952); Banks v. United States, 204 F.2d 127 (6th Cir. 1953); Remmer v. United States, 205 F.2d 281 (9th Cir. 1953); Coppola v. United States, 217 F.2d 157 (9th Cir. 1954).

answer questions or produce books and records.[14] These two amendments give the individual taxpayer the right to refuse to cooperate with the investigators, and he need not answer questions nor make his books and records available for inspection by them.

While the taxpayer has his freedom of choice and is aware of his constitutional rights, he can and must insist on them; otherwise he may waive them. This is a crucial point in a fraud case, and the making of a proper decision is very important; that is the time when he should obtain the best legal advice possible. We must be aware of the following: The taxpayer must assert his constitutional rights or he may intentionally waive them.[15] They must be asserted by the taxpayer himself since these constitutional privileges are personal.[16] Investigating agents are under no obligation to warn taxpayers of their constitutional privileges.[17] A taxpayer cannot partially assert his constitutional privileges.[18] The investigator cannot misrepresent his powers to induce the taxpayer to waive his constitutional privileges.[19] If government agents obtain through legal process access to a taxpayer's books, he does not by compliance with the process obtain immunity from prosecution.[20] In such cases the government may get a search warrant and thereby get access to the taxpayer's books and records. Thereby he or his employees may waive important constitutional rights, which should be done only if so advised by competent counsel after properly weighing all the pro's and con's of the situation involved in the presented case. It is often advisable to let the court decide the issue in such cases, and usually it may be beneficial to the taxpayer to do so.[21] The investigators may use Section 3612 of the Internal Revenue Code, where the taxpayer elects to stand on his constitutional rights, thereby having the Collector or Commissioner make a return from his own knowledge and thus compelling the taxpayer to establish his correct income[22] by allowing an inspection of his books and records.

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[14] Boyd v. United States, 116 U.S. 616 (1885); United States v. Murdock, 284 U.S. 141 (1931); Feldman v. United States, 322 U.S. 486 (1944).

[15] United States v. Johnson, 76 F. Supp. 538 (M.D. Pa. 1947); Gruden v. United States, 198 F.2d 610 (9th Cir. 1952); United States v. Stoffen, 103 F. Supp. 415 (N.D. Cal. 1951).

[16] Ziegler v. United States, 175 F.2d 924 (9th Cir. 1949); Ziegler v. United States, 174 F.2d 439 (9th Cir. 1949).

[17] United States v. Levy, 99 F. Supp. 529 (Conn. 1951); Hanson v. United States, 186 F.2d 61 (8th Cir. 1950); White v. United States, 194 F.2d 215 (5th Cir. 1952), *cert. denied* 343 U.S. 930 (1950).

[18] See note 16 *supra;* Morris v. United States, 12 F.2d 727 (9th Cir. 1926).

[19] Nelson v. United States, 208 F.2d 505 (D.C. Cir. 1953).

[20] Falsone v. United States, 205 F.2d 754 (5th Cir. 1953), *cert. denied* 346 U.S. 364 (1954); Smith v. United States, 337 U.S. 137 (1949); Shapiro v. United States, 335 U.S. 1 (1948); Himmelfarb v. United States, 175 F.2d 924 (9th Cir. 1949), *cert. denied* 338 U.S. 860 (1949); Rogers v. United States, 340 U.S. 367 (1951); Blau v. United States, 340 U.S. 159 (1950); Hoffman v. United States, 341 U.S. 479 (1950); Johnson v. United States, 228 U.S. 457 (1913).

[21] Healy v. United States, 186 F.2d 164 (9th Cir. 1950); United States v. Girganti, 197 F.2d 218 (3d Cir. 1952); Brunner v. United States, 190 F.2d 167 (9th Cir. 1951).

[22] Maroozis v. Smith, 187 F.2d 228 (9th Cir. 1951); Hyman Wagman, 10 Tax Ct. Mem. 836.

FUNCTION OF THE ACCOUNTANT AND ATTORNEY IN HANDLING FRAUD CASES

A competent accountant must determine the correct tax liability, and the attorney must determine whether or not to cooperate with the agents, and to what extent. The attorney must also consider the following problems: the right to search and seizure of books and records; the constitutional protection against self-incrimination; whether the taxpayer shall talk or stand mute; whether the taxpayer's communication with his accountant is privileged or whether the agents can get it by subpoena;[23] whether to pay a deficiency if assessed and file a claim for a refund; and if rejected whether to sue in the federal courts for it or petition the Tax Court for a redetermination of the Commissioner's assessment.[24]

CONSEQUENCES OF FRAUD PENALTY

We must realize that civil penalties can also be disastrous to clients; they can ruin them in addition to driving them out of business.[25] In addition to the fraud penalty there may be a penalty for nontimely filing of the return. Section 293(b) of the Internal Revenue Code provides for a 50% penalty in fraud cases. In normal cases the statute of limitations is three years, and runs from the date when by law the return should have been filed, and not from the date when the return was actually filed;[26] and the statute of limitations is three years where the understatement of gross income exceeds 25%.[26] Section 276(a) of the Internal Revenue Code provides, however, that the statute of limitations does not apply where fraud is proved.[26] The statute of limitations may be extended by agreement. The penalty applies for each tax year in which fraud appears.[26] Fraud must appear on the return or amended return.[26] There must be a tax deficiency before a fraud penalty can be imposed.[26] The fraud penalty attaches to the entire deficiency, fraudulent and non fraudulent.[26] A husband and wife filing joint returns are liable for a fraud penalty.[26] The estate or the personal representative of a deceased taxpayer are liable under certain circumstances.[27] The trustee in bankruptcy of a taxpayer who has been adjudicated a bankrupt is liable in certain cases.[27] The statutory transferee of the taxpayer

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[23] For a full discussion and citations, see notes 1 and 2 *supra.*

[24] For a full discussion and citations, see Berman, *Proper Procedure To Be Followed in Matters Before Tax Court of the United States,* TEMP. L.Q., Winter, 1952-1953. See also TAXES, July, 1953.

[25] For a full discussion and citations, see Berman, *The Civil Penalties of Income Tax Evasion,* KY. STATE BAR J., November, 1951; MONTHLY TAX DIGEST, March, 1952.

[26] For a full discussion and citations, see Berman, *Statute of Limitations in Income Tax Criminal Penalty Cases,* WOMEN'S LAWYERS JOURNAL, Winter, 1951-1952; and *Statute of Limitations in Income Tax Criminal Penalty Cases—A Dangerous Trap,* THE JOURNAL OF THE BAR OF THE DISTRICT OF COLUMBIA, August, 1951; NEVADA STATE BAR JOURNAL, 1951; TEXAS BAR JOURNAL, October, 1951.

[27] For a full discussion and citations, see Berman, *Liability of Fiduciary for Decedent's Unpaid Federal Taxes and That of Transferee for Unpaid Federal Taxes,* KY. L. J., November, 1953.

is liable under certain circumstances.[27] Partnerships are liable.[27] The burden of proof is on the Commissioner in fraud cases. The penalty does not apply where there is intent to defraud others rather than to evade taxes.[28] It is important to distinguish fraud from carelessness and negligence,[29] and also to distinguish fraud from honest errors of fact or of law or errors of judgment.

HOW IS ISSUE OF FRAUD AFFECTED BY RELIANCE ON ACTS OR ACTION OF OTHERS

A taxpayer cannot escape responsibility for errors in his returns, not otherwise excusable, by shifting the blame to Revenue agents, bookkeepers, accountants, lawyers, deputy collectors, etc., who have helped him in making out his return.[30] A corporation cannot shift responsibility for a fraudulent corporate return to its agents and officers. The corporation is liable for the fraud penalty if any agent acting for it commits fraud.[31] Relying on the advice of an accountant or attorney in specific items in a return may save a client from the fraud penalty but not always from the negligence penalty. In all instances the taxpayer must act in good faith, and the counsel must also act in good faith. The counsel must be reasonably competent in the matters on which advice is asked. The taxpayer must make a disclosure of the facts, so that counsel can fairly judge the problem involved; and the solution of the problem must be fairly within the scope of the matters on which counsel is giving advice or is rendering an opinion.[31] The accountant or attorney consulted by the taxpayer must be reputable and reasonably expert as to the subject on which he is consulted.[32] In other words, it is the duty of the taxpayer to show good faith, and a honest error is not ordinarily a defense.[33] A taxpayer in signing his return negatives a good faith claim as to reliance on the advice of others.

CIVIL FRAUD PENALTIES ARE SEVERE

Civil fraud penalties are cumulative. More than one penalty may be imposed to the same tax liability, as the 50% fraud penalty and the 25% failure to file penalty, cumulated with the delinquency penalty; and the negligence penalty may be cumulated with the delinquency penalty.[34] The fraud penalty

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28 Rose Russman, 3 Tax Ct. Mem. 928; Sam D. Hecht, 16 T.C. 981; Estate of Salvatore Santucci, 11 Tax Ct. Mem. 343; Henry T. Harmel, 11 Tax Ct. Mem. 599.

29 Ameen Jacob, 9 Tax Ct. Mem.; Abraham Freitag, 7 Tax Ct. Mem. 26.

30 Mark J. Davis, 8 Tax Ct. Mem. 881; Herbert Eck, 16 T.C. 511; Estate of Michael Samuels, 189 F.2d 857 (2d Cir. 1951), *affirming* 9 Tax Ct. Mem. 196.

31 Crescent Mfg. Co., 7 Tax Ct. Mem. 630.

32 Emond B. Bromson, 7 Tax Ct. Mem. 415; Internal Revenue Code, § 51, as amended by § 136(a) of the 1942 Act; Reg. 103, § 19-51-4(b), as amended by T.D. 5219, 1943 C.B. 158; Mark J. Davis, 8 Tax Ct. Mem. 881, *reversed* by 184 F.2d 86 (10th Cir. 1950).

33 Ross Bowman, 17 T.C. 681; T.A. Page, 10 Tax Ct. Mem. 443; Ohio Fruit Produce Co. 10 Tax Ct. Mem. 125.

34 Dan D. Jones, 10 Tax Ct. Mem. 781; Colonial Rubber Co., 10 Tax Ct. Mem. 434; Dominic D. Franco, 9 Tax Ct. Mem. 1158.

with the negligence penalty,[35] or all three penalties may be cumulated;[36] and civil penalties may not only be cumulated for the same tax year, but for different tax years, if warranted by the facts.[36] They are extremely severe sanctions as you can readily see from our article on "The Civil Penalties of Income Tax Evasion".[36a]

RESPONSIBILITIES OF ACCOUNTANTS, ATTORNEYS AND TAXPAYERS' AGENTS UNDER CODE AND REGULATIONS

Under Section 3793(b)(1) and Regulations 111, Sec. 29.51-4(b), accountants have often gotten into trouble when they wilfully overstepped their boundary in giving a helping hand to clients inclined to fraud.[37] Nor have attorneys been free of criminal involvement under certain circumstances where they went out of bounds.[38] The fact that taxpayer-defendant got the advice of others concerning his tax liability is relevant on the issue of wilfullness; and he is entitled to instructions that if he sought advice concerning his taxability on items involved, believed in and followed the advice, then even if the advice was wrong, the jury is entitled to consider these facts, and if they believe them, the taxpayer defendant is entitled to an acquital, for there would be absent the element of wilfullness.[39]

EFFECT OF REORGANIZATION OF INTERNAL REVENUE BUREAU AND CONGRESSIONAL INVESTIGATION OF BUREAU AND DEPARTMENT OF JUSTICE ON THE ADMINISTRATIVE PROCESSING OF FRAUD CASES

Congressional investigations in 1951 and 1952 and to date revealed irregularities, administrative decisions reached as a result of "pressure", and "corrupt practices" at various levels in the Bureau and the Department of Justice, according to the King Subcommittee; this resulted in sweeping changes in the organizational set up of the Bureau by the program known as Reorganization Plan No. 1 of 1952. The Secretary of the Treasury and the Commissioner of Internal Revenue announced in 1952 three drastic changes in the method of processing tax fraud cases by the Bureau: abandonment of its "health policy",

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[35] See note 33 *supra.*

[36] See note 33 *supra.*

[36a] See note 3 *supra.*

[37] Newton v. United States, 162 F.2d 793 (4th Cir. 1947); Soeder v. United States, 142 F.2d 236 (6th Cir. 1944); Schenck v. United States, 126 F.2d 702 (2d Cir. 1942); United States v. Borgis, 182 F.2d 274 (7th Cir. 1950); Murill v. State Board of Accountancy, 218 F.2d 569 (5th Cir. 1950); United States v. Wolf, 102 F. Supp. 824 (W.D. Pa. 1952).

[38] Rheb v. Bar Assn. of Baltimore City, 186 Md. 200, 46 A.2d 289 (1945); United States v. Kelley, 105 F.2d 912 (2d Cir. 1939); United States v. Rosenblum, 176 F.2d 321 (7th Cir. 1949); G.C.M. 14509; XIV-1CB84.

[39] Haigler v. United States, 172 F.2d 986 (10th Cir. 1949); Olson v. United States, 191 F.2d 985 (8th Cir. 1951); United States v. Raub, 177 F.2d 312 (7th Cir. 1949); Lurding v. United States, 179 F.2d 419 (6th Cir. 1950).

abandonment of its "voluntary disclosure policy", and decentralization of the reviewing process.

Tax experts who were acquainted with the practice developed in the Penal Division of the Bureau knew and took advantage of the existence of its "health policy". It was, in effect, that the Bureau would not recommend criminal prosecution where "health questions" were involved in spite of the fact that all other factors justified prosecution, especially so where in the opinion of the government medical experts "standing trial would endanger the taxpayer's life or sanity." This policy led to abuses and the escape from prosecution and jail sentences of flagrant violators.[40] The "health" of a taxpayer is still given serious consideration in the Department of Justice.

For a good many years prior to 1945 an unannounced "voluntary disclosure" policy was adhered to in the Bureau's Penal Division, to the effect that if a taxpayer made a "voluntary disclosure" before an investigation as to his status started, the Bureau would not recommend that criminal action be taken in addition to vigorous enforcemnt of civil penalties.

In 1945 the Secretary of the Treasury publicly announced the existence in the Bureau of this policy. As a result of this publicity, it became generally known; and in the following years taxpayers rushed to take advantage of it in great numbers.

The Bureau strove for the position, and the courts generally maintained it, that the "policy" was a matter of grace and not a right, that the Bureau had the sole right to determine for itself whether in a particular case the taxpayer met its standards as to whether an effective voluntary disclosure took place, and that its decision in regard to it was immune from judicial interference or repudiation.

A good many taxpayers claimed that in spite of the fact of the "voluntary disclosure", they were nevertheless indicted.

In 1950 the United States District Court in the *Liebster* case[41] upheld the taxpayer in his plea and held that he had not waived his constitutional rights against self-incrimination, and ordered the suppression of evidence in grand jury proceedings when the government sought to indict him on the basis of his books and records and oral statements given by him to the Bureau agents relying on their tacit representation ("by their silence") that an effective voluntary disclosure was made. The government did not appeal this case; thereby

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[40] Hearings of the Subcommittee on Ways and Means, House of Representatives, January 22-25, 1952, pp. 131-138; House Report No. 2518, United States Government Printing Office, Washington, D. C., 1953, pp. 10-11.

[41] 91 F. Supp. 814 (E.D. Pa. 1950).

admitting its inherent weakness on October, 1950, the Solicitor General authorized "no appeal" in the *Liebster* case.

The Bureau was criticized for its failure to establish reasonable standards which it would consider sufficient to bring about the application of the "voluntary disclosure policy" in a specific situation. The King Subcommittee showed instances in which taxpayers of bad character have avoided criminal prosecution by way of the "voluntary disclosure" device on the advice of "shrewd" counsel.

On January 10, 1952, the Secretary of the Treasury suddenly announced that the Bureau had abandoned its voluntary disclosure policy and that in the future criminal prosecutions would not be influenced by it. In view of the lack of unanimity on the part of top level Treasury and Bureau personnel in regard to the abandonment of the above mentioned "voluntary disclosure policy", *it may still apply in genuine* "voluntary disclosures by taxpayers" before an investigation of his tax status has started, and will continue to be an important element in weighing the question of wilful evasion even though not justified on the basis of a declared "policy". The Bureau will recommend criminal prosecution of the "racketeer" type of individual on the basis of a "prima facie" showing of wilful evasion.

The Department of Justice never had a "voluntary disclosure" policy of its own. If the Bureau declined to recommend prosecution of this ground, the Department of Justice did not interfere with this decision, and if the Bureau sent the case to the Department of Justice for prosecution, it assumed by this act that the voluntary disclosure issue, if presented, had been decided adversely to the taxpayer It is most likely that now that the Bureau has abandoned its "voluntary disclosure policy" that the Department of Justice does not desire to establish a "voluntary policy" of its own, but it would most likely give weight to an essential claim that a true voluntary disclosure took place. This will not prevent prosecution but will be considered as an element in determining whether in view of the facts it is reasonable to assume that a conviction would follow the bringing of criminal charges in such instances. It is reasonable to assume, therefore, that for the foreseeable future criminal prosecutions for tax evasion will increase. The Tax Court in numerous cases held that "intent to defraud" is the essential factor for the civil fraud penalty and that it must be proved by "clear and convincing" evidence of fraud, and not by suspicion, doubt, or surmise. This does not, however, apply to criminal tax evasions.[42]

Conclusions on New Policy on Reconstructing of Net Income

The Government disregards the books and records of taxpayers that are poorly kept, and reconstructs their income on the basis of bank deposits, net

[42] For a full discussion and citations, see notes 2 and 3 *supra* and Berman, *The Advisability of Entering into Closing Agreements and Compromises in Federal Tax Cases,* Miss. L. J., May, 1954.

worth plus living expenses, or a percentage mark-up where gross sales or purchases are ascertainable and inventories are a necessary income-producing factor.

The law provides that persons liable for income taxes must keep the necessary records that will reflect their income.[43] Farmers and wage-earners (with no other income than these sources) are exempt by the regulations from the above requirement.[44] Wilful failure to comply with the above is a misdemeanor, punishable as such.[45] If books and records are not kept as provided by law, "the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income."

Failure to file a return is often linked with failure to keep records of income. Such a failure may be due to negligence, or it may be fraudulent if the person is trying to conceal the source of his income. There are three methods used by the government in reconstructing income. These are: the bank deposits-expenditures method, the net worth-living costs method, and the percentage or unit mark-up basis.

BANK DEPOSIT-EXPENDITURES METHOD

It is assumed under this method that all bank deposits represent income, unless the taxpayer can prove otherwise. The only allowable deductions are those which the taxpayer can prove. In addition, the examing officer ascertains cash receipts not deposited in a bank, which may have been used for living expenses. Since they are not deductible, they are added to the bank deposits to arrive at the gross income. This method is used in the cases of gamblers or others who derive income from illegal activities, professional people who fail to keep records, and persons whose income is derived from salaries, dividends, rents, etc. It is not used in cases of merchants, since the bank deposits in such cases may represent gross sales, without reduction for allowable cost of goods sold, in order to arrive at gross income. It can, however, be combined with the percentage or unit mark-up basis.

In such cases the taxpayer should be given an opportunity to show that the deposits do not represent income. If he cannot do so, the Commissioner will prevail. In such cases the court also upheld the penalty.[46]

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[43] Internal Revenue Code, § 51.

[44] Reg. 111, § 29.54-1.

[45] Internal Revenue Code, § 143(a).

[46] Goe v. Com., 198 F.2d 851 (3d Cir. 1952).

NET WORTH-LIVING COSTS METHOD

This is often a more satisfactory method of reconstructing income than the bank deposits method. It also may be used to bolster up an income figure that has been arrived at by the use of the bank-deposits expenditures method. Under the net worth method of determining income, a balance sheet is prepared as of the beginning and end of the taxable year; the increase in net worth during the year is thus determined. To this are added all expenditures during the year for nondeductible living costs and luxuries which do not represent assets appearing on the closing balance sheet. This method is used in cases of merchants, manufacturers, investors, or other types of taxpayers.[47]

PERCENTAGE OR UNIT MARK-UP METHOD

This method is used where inventories are necessary income-determining factors but were not kept or were incorrectly taken. In order to use this method the amount of gross sales or purchases must be known.

The Supreme Court of the United States finally recently set at rest and upheld the net worth law as previously decided by the lower federal courts.[48]

GENERAL CONCLUSIONS

1. A taxpayer who is grossly negligent in keeping books and records will pay more tax eventually than otherwise would have been the case had he kept accurate records.

2. If no accurate records are kept, the Commissioner can reconstruct the taxpayer's income, which under the best circumstances is an approximation; and, therefore, since the inexactitude is due to his own fault, he, rather than the government, will suffer.

3. The Commissioner can successfully treat unidentified bank accounts as income without offsetting unidentified expenditures against it.

4. The net-worth living costs method is more equitable in reconstructing income. The Commissioner's figures so arrived at are accepted by the Tax Court in a greater number of cases than those in which the income is based on bank deposits.

5. The taxpayer in such cases may be seriously damaged since the income earned at some time may arbitrarily be attributed to the wrong year, or lumped in one year, for which tax rates are unusually high.

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[47] J. Baker Bryan, 10 Tax Ct. Mem. 989; Annie Mary Timmons, 11 Tax Ct. Mem. 944.

[48] Holland v. United States, 348 U.S. 121 (1954); Friedberg v. United States, 348 U.S. 142 (1954); Smith v. United States, 348 U.S. 147 (1954); United States v. Calderon, 348 U.S. 160 (1954).

6. There is also the danger of overvaluation of assets other than cash in determining closing net worth if the taxpayer can not prove his costs. The Tax Court favored changing reconstructed income from the Commissioner's bank-deposit method to the net worth basis.

7. The percentage-mark-up method is the least likely to be fair to the taxpayer, being used where inventories are an income-producing factor; but the Commissioner may use it if the taxpayer in refuting unreasonably high income figures is often serious in time lost, heartache, and loss of money.

8. Former utmost consideration given taxpayers suspected of criminal tax evasion by the administrative processes existing in the Bureau and the Department of Justice may have been forever abandoned.

9. The abandonment of the "health" and "voluntary disclosure" policy by the Bureau and the emasculation of both factors as deterrents to recommending criminal prosecution to the Department of Justice are evidence of a change in emphasis from enforcing the criminal provisions of the tax laws as an incident to raising revenue and to enforcing them to deter evasion.

10. Administrative settlements of acute evasion cases on a civil liability basis will be less frequent and more difficult.

11. A close study of judicial declarations compels us to revalue the reliance to be placed by taxpayers and their counsel on constitutional rights and privileges, during the investigation of a case and afterwards.

12. The change in administration after twenty years in office of a major political party whose policies were reflected along administrative assembly lines must be considered.